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DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 00-0236 and 00-0237
Sales/Use Tax Assessments
For Tax Periods: 1996 through 1998

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Sales/Use Tax — Duplicate Assessments

Authority: IC 6-2.5-3-2

Taxpayer protests duplicate assessments of Indiana use tax on purchases of supplies and materials.

II. Sales/Use Tax — Characterization of Restaurant Equipment

Authority: *Indianapolis Fruit Co., v. Department of State Revenue*, 691 N.E.2d 1379 (Ind.Tax 1998)
Sales Tax Information Bulletin #55

Taxpayer protests Audit's characterization of restaurant equipment.

III. Sales/Use Tax — Electric Utility Study

Authority: IC 6-2.5-4-5(c); IC 6-2.5-5-5.1

Taxpayer protests Audit's modifications of taxpayer's utility study.

STATEMENT OF FACTS

Taxpayer owns and operates two (2) restaurants in the state of Indiana. An examination of taxpayer's invoices for the calendar years 1996, 1997, and 1998 shows that taxpayer failed to pay sales tax on certain items of tangible personal property for which no exemption applied. Audit also questioned taxpayer's conclusions concerning the use of certain metered utilities.

This audit resulted in proposed assessments of use tax. Taxpayer now protests these assessments.

I. Sales/Use Tax — Duplicate Assessments

DISCUSSION

Taxpayer purchased certain items exempt from Indiana gross retail (sales) tax—i.e., coupon books, charge sales tickets, letterhead stationary, checks and envelopes, order and batch tickets, and birthday club postcards and registrations. According to Audit, taxpayer purchased these items for *use* by its two Indiana restaurants as well as for *resale* to other restaurateurs. Audit proposed assessments of use tax on the items *purchased and used* by taxpayer.

Taxpayer does not protest the substance of these assessments. Rather, after reviewing the audit report, taxpayer noticed that each proposed assessment appeared twice—one time for each restaurant. At first blush, it appeared as if two assessments were proposed for each nonexempt purchase made. After further investigation, taxpayer recognized that while each proposed assessment was listed twice, the dollar amounts associated with these "duplicate entries" represented each restaurant's apportioned share of a single assessment. Taxpayer has withdrawn its protest of this issue.

FINDING

Taxpayer's protest has been withdrawn. No further action is required.

II. Sales/Use Tax — Characterization of Restaurant Equipment

DISCUSSION

Taxpayer questions the characterization of some of its restaurant equipment for purposes of determining the percentage of electricity consumed in its production process. Specifically taxpayer contends that a large walk-in refrigeration unit and an exhaust filter system should have been characterized as production equipment for purposes of computing exempt utility consumption.

Taxpayer cuts and "ages" its own steaks. According to taxpayer, the aging process requires restaurant personnel to store purchased beef in a refrigeration unit prior to final cutting and subsequent cooking. Taxpayer believes the refrigeration unit is an essential an integral part of its production process. The "aging process" at issue consists of placing meat in a controlled refrigerated environment. Cold storage allows natural enzymes to breakdown the hard connective tissues. The result is a tender, more flavorful product. Given the refrigerator's utility, taxpayer contends the unit is essential to its integrated production process.

The Indiana Tax Court has heard, and rejected, similar arguments. In *Indianapolis Fruit Co., v. Department of State Revenue*, 691 N.E.2d 1379 (Ind.Tax 1998), taxpayer (Indianapolis Fruit) argued that tomatoes were ripened and made more marketable through storage "in a tightly controlled environment." *Id* at 1385. The Tax Court rejected this argument and found that tomato ripening did not constitute production. As the Court stated:

> This Court finds that the tomato ripening does not constitute production within the meaning of any of the exemption provisions. It is indisputable that, like the bananas, the tomatoes have undergone a substantial physical and chemical change while ripening. Although this transformation undoubtedly made the tomatoes far more marketable, the transformation was not triggered by Indianapolis Fruit. Instead, it passively awaited the ripening of the tomatoes. The ripening was not actively induced by Indianapolis Fruit and was merely incidental to the proper storage of the tomatoes.

Id at 1385-86.

This same logic precludes the Department from arriving at a different conclusion. Taxpayer's "aging" of beef does not represent a production activity. Audit's refusal to characterize the refrigeration unit as production equipment was correct.

Additionally, taxpayer argues that an exhaust filter system (exhaust system located in cooking areas) should be characterized as production equipment. However, from taxpayer's description of the exhaust filtration system, the Department understands the system's function to be one of safety and health—not production. Characterization of this equipment as production for purposes of determining the amount of electricity consumed in taxpayer's *production* process, therefore, would be incorrect.

Sales Tax Information Bulletin #55: Application of Sales Tax to Sales of Utilities Used in Manufacturing or Production, May 31, 1989 (Revised), provides the following relevant example:

> The taxpayer is a restaurant that purchases electricity used to power air conditioning and ventilating equipment. The equipment environmentally conditions the kitchen area of the restaurant. The equipment is not exempt under 45 IAC 2.2-5-8 through 45 IAC 2.2-5-11 because it does not operate in an integrated fashion with the food production process and is not essential to making that process possible. Consequently, the electricity used in conjunction with that equipment is not exempt under Indiana Code 6-2.5-4-5.

FINDING

Taxpayer's protest is denied.

III. Sales/Use Tax — Electric Utility Study

DISCUSSION

Taxpayer questions the methodology used by Audit for determining the percentage of taxpayer's exempt utility consumption. Taxpayer contends over fifty percent (50%) of the electricity purchased is consumed in production activities. Given predominant use, taxpayer believes it is entitled to the one hundred percent (100%) exclusion provided by IC 6-2.5-4-5(c).

Electricity directly consumed in the direct production of other tangible personal property by a business engaged in "manufacturing, processing, refining…" is exempt from sales tax. IC 6-2.5-5-5.1. This *exemption* is applied on a pro rata basis. An *exclusion* is provided for sales made by public utilities if the services sold (i.e., the electricity purchased) are "consumed as an essential and integral part of an integrated process that produces tangible personal property and those sales are separately metered for the excepted uses…or if those sales are not separately metered but are predominately used by the purchaser for the excepted uses listed in this subdivision." IC 6-2.5-4-5(c).

In this instance, Taxpayer's electricity purchases were not separately metered. Therefore, sales to taxpayer would qualify for the predominant use exclusion if over fifty percent (50%) of taxpayer's electricity purchases were consumed in production activities.

Taxpayer provided the Auditor with a listing of electrical equipment, usage (hours), and draw (KWH), by location. Taxpayer's calculations showed that both Indiana locations qualified for the predominant use utility exclusions. Audit questioned the usage assigned to selected equipment. As Audit explained, "[t]he taxpayer's hours were adjusted to what the [D]epartment consider[ed] to be a normal operating range based on experience with similar taxpayers." Taxpayer disagreed.

The Department believes that taxpayer's usage of electrical utilities for production purposes should have been derived from empirical evidence. Audit, therefore, must revisit taxpayer's locations in order to compute these production percentages.

FINDING

Audit will revisit this issue pursuant to the aforementioned language.